DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: DEBORAH BUTLER
Assistant Chief Counsel CC:DOM:FS

SUBJECT: Premiums paid for captive insurance

This Field Service Advice responds to your memorandum dated May 4, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer =
C =
D =
E =
F =
G =
H =
J =
P =
Country A =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
$a = $
$b = $
$c = $
$d = $
$e = $
$f = $

$g	= $
$h	= $
$j	= $
k%	= %

ISSUE:

Whether Taxpayer and its subsidiaries are entitled to deductions for “insurance” premiums paid to C pursuant to a brother-sister captive insurance arrangement.

CONCLUSION:

We do not object to your recommendation to concede this case. Nevertheless, we have also discussed several factors present in this case which, if more fully developed, could have been used as a basis for challenging the taxpayer’s characterization of the transactions at issue as insurance.

FACTS:

P owns the following entities: (1) Taxpayer, a U.S. corporation; (2) H, a finance company incorporated in Country A; and (3) C, a captive insurance company also incorporated in Country A. Taxpayer in turn owns four operating subsidiaries, D, E, F, and G. P formed C in Year 1 with the purpose of insuring the risks of Taxpayer and Taxpayer’s operating subsidiaries. P made an initial capital contribution to C in the amount of $c

Prior to Year 1, Taxpayer and its operating subsidiaries were self-insured. In Years 1 through 4, C entered into “insurance” agreements with Taxpayer and its operating subsidiaries. Since Taxpayer and C are owned by a common parent, these transactions are what is commonly referred to as “brother-sister” captive insurance transactions. Pursuant to these agreements, C agreed to provide coverage for the first $a of property risks, and for the first $b of automobile liability, general liability, and workman’s compensation risks. Although it is not clear from the materials submitted, it appears that these coverage limits were applicable on a per occurrence basis. Taxpayer and its operating subsidiaries paid premiums to C in accordance with rates determined by J, an independent actuarial consulting firm. The premiums paid totaled $d in Year 1, $e in Year 2, $f in Year 3, and $g in Year 4.

In addition, C made loans to H during Years 1 through 4 in the total amount of $h. The total loans made to H from Years 1 through 4 represent k% of the total premiums paid by Taxpayer and its operating subsidiaries to C during those years. The terms of these loans are not reflected in the materials submitted.

The taxable years at issue are Years 2 through 4. On its federal income tax returns for those years, Taxpayer, D, E, F, and G claimed deductions for the premiums paid to C.

LAW AND ANALYSIS:

Generally, premiums paid for insurance are deductible under I.R.C. § 162(a) if directly connected with the taxpayer's trade or business. Treas. Reg. § 1.162-1(a). Although the Internal Revenue Code does not define the term "insurance," the United States Supreme Court has explained that to constitute "insurance," a transaction must involve "risk shifting" (from the insured to the insurer) and "risk distribution" (by the insurer). Helvering v. Le Gierse, 312 U.S. 531, 539 (1941). In this regard, amounts set aside by a taxpayer as a "self-insurance" reserve for anticipated losses are not insurance expenses because risk is not shifted from the taxpayer; therefore, such amounts are not deductible until the taxpayer actually pays or accrues the anticipated loss. United States v. General Dynamics Corp., 481 U.S. 239, 243-244 (1987).

In instances where the taxpayer enters into an "insurance" arrangement with a related "insurance" company, the Service has considered whether sufficient risk shifting is present in order for the transaction to be considered insurance. In Rev. Rul. 77-316, 1977-2 C.B. 53, the Service addressed three situations whereby a taxpayer attempted to seek insurance coverage for itself and its operating subsidiaries through the taxpayer's wholly-owned captive insurance subsidiary. The ruling explained that the taxpayer, its non-insurance subsidiaries, and its captive insurance subsidiary represented one "economic family" for purposes of the risk-shifting analysis. Accordingly, the Service concluded that the transactions were not insurance to the extent that risk was retained by the captive insurance subsidiary. Therefore, the premiums paid by the taxpayer and its non-insurance subsidiaries to the captive insurer were not deductible.

No court has fully accepted the economic family theory as set forth in Rev. Rul. 77-316. With respect to brother-sister captive insurance transactions, both the United States Court of Appeals for the Sixth Circuit and the United States Court of Federal Claims have held that payments to a captive insurer by its sibling subsidiary were deductible as insurance premiums. Humana, Inc. v. Commissioner, 881 F.2d 247 (6th Cir. 1989); Kidde Industries, Inc. v. United States, 40 Fed. Cl. 42 (1997). In both Humana and Kidde, the captive in question insured risks only within its related group. Both courts reasoned that sufficient risk shifting existed with respect to the brother-sister transactions because a loss incurred by the insured subsidiary did not diminish the assets reflected on that subsidiary's balance sheet when the captive paid claims. Relying upon the doctrine of separate corporate existence set forth in Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 439 (1943), each court explained that brother-sister transactions should be considered insurance for

Federal income tax purposes unless either the captive entity or the transaction itself is a sham. Humana, 881 F.2d at 255; Kidde, 40 Fed. Cl. at 47.

In Malone & Hyde v. Commissioner, 62 F.3d 835 (6th Cir.1995), the Sixth Circuit in applying the above analysis to a brother-sister insurance transaction concluded that the captive insurer was a sham and thus held that the payments were not deductible as insurance premiums under section 162(a). In determining that the captive insurance company was a sham corporation, the court noted that the parent propped up the captive by guaranteeing its performance, the captive was thinly capitalized, and the captive was loosely regulated by the locale in which the captive was incorporated (Bermuda). Id. at 840. Other factors considered in determining whether a captive insurance transaction is a sham include: whether the parties that insured with the captive truly faced hazards; whether premiums charged by the captive were based on commercial rates; whether the validity of claims was established before payments were made on them; and whether the captive's business operations and assets were kept separate from its parent's. Ocean Drilling & Exploration Co. v. United States, 24 Cl. Ct. 714, 728-729 (1991), aff'd, 988 F.2d 1135 (Fed. Cir. 1993).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted] In this regard, there are two factors present in this case which militate against a conclusion that the transactions at issue are insurance: (1) C is undercapitalized and (2) a significant portion of the premiums paid were to C were borrowed by H, thereby raising concerns about circular flows of cash.

With respect to undercapitalization, the industry standard as established by the National Association of Insurance Commissioners (NAIC) is that insurers should have $1 of surplus for every $3 of net written premiums; in this case, however, there was $1 of surplus for every $j of net written premiums in Year 1.[1] Depending upon the facts of a particular case, a premium to surplus ratio of j:1 may increase the likelihood of the insurer's insolvency such that risk would be effectively retained by the insured. See Humana, 881 F.2d at 254 n.2 (suggesting the undercapitalization alone could preclude risk shifting). We cannot derive that conclusion in this case because we have no evidence that, given the risks insured in question, C's undercapitalization threatened its solvency. [redacted]

With respect to the loans from C to H, we first note that the terms of the loans are not included with your submission. Depending upon the facts of a particular case, the presence of circular flows of cash may indicate self-dealing, and could undermine a taxpayer's argument that the captive insurer was an independent entity that negotiated the terms of the "insurance" transactions at arm's length. Since the facts concerning these loans between C and H are not clear, we cannot determine whether the resulting circular cash flows affect whether the transactions at issue are "insurance."

Despite these concerns, we agree with your conclusion that, given the factual development in this case, the Service is unlikely to prevail on this issue. Nevertheless, we note that had this case been more fully developed, the factors discussed infra may have been used as a basis for challenging the taxpayer's characterization of the transactions at issue as insurance.

Accordingly, we do not object to your recommendation to completely concede this issue.
If you have any have any further questions, please call (202) 622-7870.

DEBORAH BUTLER
Assistant Chief Counsel (Field Service)

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[1] An annually-issued NAIC handbook, Using the NAIC Insurance Regulatory Information System, sets forth a recommended premium to surplus ratio of 3:1, as well as other ratios relating to insurers' solvency. The purpose of the handbook is to assist state insurance examiners in identifying potentially troubled insurers. See generally Insurance Accounting and Systems Association, Property-Casualty Insurance Accounting at p. 2-8 (6^{th} ed. 1994)

By: ______________________________

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